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***PERMANENT ESTABLISHMENT IN DIGITAL ECONOMY***

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## PERMANENT ESTABLISHMENT IN DIGITAL ECONOMY

*Akanksha Yadav\**

**[Abstract:** *Due to the rapid increase of ecommerce and the transactions of the same, the enterprises have an increased digital presence which has made it even more difficult to establish their link to the nations in which they are operating and hence, permanent establishment becomes an important aspect to look into. If a permanent establishment of an enterprise is established, then it becomes quite easy to track the enterprises transactions and revenue and tax the same for the nation state. Presently, the definition of permanent establishment requires a degree of fixation which is not available to the digital markets and hence, this leads to the difficulty of taxation of such platforms. This paper would try to answer whether there is a need to amend the definition of Permanent Establishment in light of digital economy while discussing the law governing it at present and the judicial pronouncements that have contributed to the development of this concept.]*

**Keywords:** *Permanent Establishment, International Taxation, Digital Economy, Virtual Permanent Establishment*

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# I

## INTRODUCTION

The working of the established regulations governing the distribution of taxing rights and responsibilities between the resident and source nations has come under special danger from the advent of the digital economy. A foreign business can offer online professional services to clients in a market nation, receive payment, and create profits without being subject to income tax. The old principles on tax allocation may no longer be a sufficient mechanism to protect the tax rights of a nation in the digital age, which heavily relies on digital technology to conduct essential company operations, whether they are dependent on physical or representative presence. The digitalization of business activities has reduced the necessity for a physical presence in the source country, which presents a number of international tax-related policy challenges,<sup>1</sup> particularly when establishing nexus with a jurisdiction to tax corporate revenues. This is a result of the distinctive characteristics of digital enterprises' business models.

The economy has seen substantial global changes as a result of the use of digital technology, and this has led to an increase in the global redistribution of value-adding activities. There is a need to concentrate on the tax issues facing the digital economy even if this process has resulted in a number of political, economic, and social challenges. The limitations on the scope of these studies are related to the analyses on issues of direct taxation and, more specifically, related to company income taxes in connection with cross-border activities, even though similar difficulties may be seen, more or less, in every area of taxation. At the moment, this is the area of taxation where more effective action is demanded.

The first step in offering a solution to the current issues the digital economy is currently facing is understanding the characteristics of the new business models. As a result, the following traits are deemed essential by the OECD in the BEPS Action 1 Final Report, that is, volatility, network effects, reliance on data and user interaction, inclination toward monopoly or oligopoly, and mobility. The OECD's report also points out that not all of the elements mentioned above may be present in any single business model in the digital economy. Instead, these are the traits that, on the whole, seem to define the economy of the 21st century. It is very difficult to establish the difference between the digital economy and the traditional economy<sup>2</sup> and, thus, these

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<sup>1</sup> Organisation for Economic Cooperation and Development, BEPS FINAL REPORT 109 (2015).

<sup>2</sup> Michael P. Devereux & John Vella, *Debate: Implications of Digitalization for*

key features tend to become stronger in the following years.

## II

### FEATURES OF A DIGITAL ECONOMY

**Mobility:** One of the primary reflections in the increase in mobility in the digital economy is the raising in value of intangibles. Nowadays, immaterial property represents a large amount of a companies' value, as represented by the heavier reliance on software, royalties, trademarks and other elements.<sup>3</sup>

**Data and user participation:** The utilisation of data, information, and user interaction has long been a feature of corporate activity and is not unique to the digital economy. Companies can now gather a far greater amount of data from users and customers. Due to the expansion of the facility and the volume of data, it has evolved into a crucial component of company activity rather than just a supporting one. The reliance on data can be demonstrated by the enormous amount of value that it can bring to businesses that are interested in selling it, or, on the other hand, by the fact that, through the "reading" (processing) of these data, businesses are able to "outsource" some business operations, such as quality control or product description, to customers and users.

**Network effects:** The network effect is a property of the user participation concept that is potentialized by the digital economy. Thus, it is evident that in some business models, the value of a product might increase in proportion to the number of users or consumers for that particular product. Other noteworthy examples from today include using social media or more widely used technologies. On the other hand, platforms that provide transportation or lodging services handled by independent third parties rely, typically, on the presence of multiple users sharing their experiences and influencing or discouraging others to purchase the specified goods or services without receiving a specific payment for doing so.

**Use of multi-sided business models:** The multi-sided model technique can be used more widely in the digital economy because distinct parts or components of a particular firm can be located in various jurisdictions and even provided by various undertakers. The large number of free online news websites, social

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*International Corporate Tax Reform*, 46 INTERTAX 550 (2018).

<sup>3</sup> Oddleif Trovik, *The Allocation of Residual Profits from Unique and Valuable IP to Permanent Establishments in Transfer Pricing and Intangibles – US and OECD arm's length distribution of operating profits from IP value chains*, 45 IBFD DOCTORAL SERIES 11 (2019).

media platforms, virtual games, and others that have their investment paid for by the sale of advertisement space to be viewed by the final user of the specified online product serve as an excellent illustration of this. When businesses can share the costs of an investment and customers may freely get the desired items, a positive externality has been proven here.

### III

#### **ESTABLISHED PRINCIPLE OF PERMANENT ESTABLISHMENT**

As per Article 5(1) of OECD, it is established, the OECD Convention has three-step criteria for determining whether a certain corporate presence qualifies as a PE. There is a need to consider the following to establish PE in any jurisdiction, that is, a distinct place of business, the place must be fixed to establish a degree of permanence and the business of the enterprise must be carried out through that fixed place of business.

**Distinct Place of Business:** It means any territory, machinery, or equipment.<sup>4</sup> There is no need for such a place to have a separate location to be created or used only for the entity's operations. For instance, it suffices that the proposed permanent establishment has access to another business' space.

**Fixed Place of Business:** A specific location on foreign soil that has a particular level of permanence is referred to as a place of business which is fixed in nature. There need for an association between the location of the business which is in issue and location of that particular geographical location.<sup>5</sup> It is simple to determine where business operations are conducted from a particular place that the undertaking uses to conduct such operations. Because of this, policymakers introduced the concept of a dependent agent when drafting of OECD's Article 5. This concept has led to expansion of the concept of PE by including a person acting for the foreign company, who may be an employee or another dependent actor. It is important to refer to clause 5 of Article 5 of the OECD in the absence of any physical premises in order to determine whether the current situation qualifies as an agency-based PE.

### IV

#### **BEPS AND THE DIGITAL ECONOMY**

Base Erosion and Profit Shifting, or BEPS, are tax planning techniques that take advantage of discrepancies and inconsistencies in tax laws to artificially

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<sup>4</sup> Organisation for Economic Cooperation and Development, MODEL TAX CONVENTION ON CAPITAL AND ON INCOME (2017).

<sup>5</sup> *Id.*

move earnings to low- or no-tax jurisdictions with little to no economic activity, resulting in little to no overall corporation tax being paid. Numerous crucial aspects of the digital economy, especially those involving mobility, raise BEPS issues with regard to both direct and indirect taxes.

There are three important phenomena facilitated by digitalisation – scale without mass, reliance on intangible assets, and the centrality of data which pose serious challenges to global tax system and in turn result in tax evasion.<sup>6</sup> Compared to traditional brick-and-mortar enterprises, shifting the location of a business may be easier in a digital economy. Digital businesses frequently have the freedom to function remotely and carry out commercial operations from many locations without having a sizable physical presence. The development of technology, communication tools, and the internet has made this easier. Digital businesses can set up virtual offices, work in cloud settings, and have distributed teams that are headquartered in different places. Without the requirement for a significant physical infrastructure, they can easily set up operations in multiple countries or relocate their major operating site.

To deal with this problem, along with the proposed amendment to Permanent Establishment definition, an inclusive framework on BEPS by OECD has proposed a solution. The Two-Pillar Solution has been established to modernise international taxation laws and guarantee that multinational corporations pay a fair share of tax wherever they operate.

*Pillar One is the Re-allocation of taxing rights:* In relation to the digital enterprises, Pillar One will enable a more equitable division of profits and taxing rights across nations.<sup>7</sup> Regardless of whether companies have a physical presence there, it would transfer some taxing authority from home nations to the regions where they conduct business operations and generate revenues.

*Pillar Two is a call for Global anti-base erosion mechanism:* Pillar Two introduces a global minimum corporation tax rate that nations might use to safeguard their tax bases in an effort to put a floor under competition over corporate income tax.<sup>8</sup>

## V

### ESTABLISHING DIGITAL PERMANENT ESTABLISHMENT

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<sup>6</sup> Organisation for Economic Cooperation and Development, BEPS ACTION 1, TAX CHALLENGES ARISING FROM DIGITALISATION (2021).

<sup>7</sup> Organisation for Economic Cooperation and Development, TAX CHALLENGES ARISING FROM DIGITALISATION – INTERIM REPORT (2018).

<sup>8</sup> *Id.*

## THROUGH A DIGITAL PRESENCE

The earliest action to look upon the problems that were brought in by the digital economy was the Ottawa Conference, which was sponsored by the OECD in 1998<sup>9</sup>. It was established in the conference's conclusions that electronic commerce would be a worldwide notion by definition. The OECD had addresses that unless a global action was taken, the problems due to a digital economy could not be addressed by any nation alone<sup>10</sup>. The OECD stressed that the critical part that government cooperation will play in formulating public policy.

Developments around the world aiming to tax digital services effectively. The primary goals of implementing a digital PE are to weaken the current Article 5 of the OECD Convention requirement for a physical presence that would be permanent in nature in a particular area outside of the company's resident state and to create a nexus for including that area in taxation<sup>11</sup>. In an effort to combat such issues of tracking the digital presence of companies, OECD focused on bringing a change in the definition of PE which was later recommended in 2020.

A well-functioning concept of digital PE requires negotiation and agreement at least on a bilateral level and ideally on an international level. Multilateral agreements are typically very difficult to establish and typically create soft guidelines rather than binding legal sources because tax rules are usually left to state discretion due to the idea of sovereignty. However, a multilateral soft law instrument would probably make it easier for new taxing regulations to spread beyond national levels.

The OECD initially evaluated the expansion of the PE concept to firms with considerable digital presence as a separate option from significant economic presence. BEPS proposed one of the measures to stop this tax avoidance. BEPS took the initiative to change the PE idea, and as a result, it handled the circumstances by tying together the commercial operations that involve alleged contrived arrangements. The proposed new definition of PE and the expansion of the same made by BEPS was its most significant contribution. The inclusion would mean that an organisation could not take use of any of the exceptions in the definition of Permanent Establishment under Article 5 of the OECD if its primary activities of business are carried out in a non-domestic territory. The states have not agreed to the suggested modification to the

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<sup>9</sup> Organisation for Economic Cooperation and Development Ministerial Conference, *A Borderless World: Realising the Potential of Global Electronic Commerce* (1998).

<sup>10</sup> *Id.*

<sup>11</sup> *Supra* note 7.



definition of PE. The OECD's 2018 Interim Report included a thorough investigation of the how and where of value creation across numerous digital models across different nations. The interim report also provided a summary of the evolution of tax law at the time as it pertained to digital markets. Due to the fact that even traditional non-digital enterprises use digitalization to a significant extent, such a digital PE would not distinguish between digital and non-digital companies<sup>12</sup>. As a result, there may be problems with tax neutrality if enterprises are divided into traditional and digital categories. Additionally, it would be challenging to distinguish between the two business models in actuality.

## VI

### VIRTUAL PERMANENT ESTABLISHMENT UNDER OECD

The guiding principles for the creation of international taxation for electronic transactions and trade came into existence in 1998. Based on research of advisory groups, the OECD published a paper in 2005 titled "Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-Commerce?". The "VPE" paradigm was investigated by the OECD in this research as a potential alternative nexus for electronic commerce operations. According to such report, the PE definition requires to be extended as follows:

- (i) A "Virtual fixed place of business" through which the enterprise carries on business in any state. That is, the presence of a web site on a server of another enterprise located in a jurisdiction and the business continues by the use of that website, a permanent establishment can be established and the place of business is virtual in the form of the web site.
- (ii) A "Virtual agency," is a notion that refers to an electronic version of an agency PE which will include circumstances in which contracts as well as negotiations are habitually held and entered into behalf of the enterprise with people who are located in the jurisdiction by technology means rather than through a physical presence.
- (iii) A "On-site business presence", which can be defined to include a presence which is virtual. To assure that source country taxes only take effect when there is a sizable amount of economic activity, it

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<sup>12</sup> Organisation for Economic Cooperation and Development, ARE THE CURRENT TREATY RULES FOR TAXING BUSINESS PROFITS APPROPRIATE FOR E-COMMERCE? (2004).

would be required to define a minimum threshold under this choice. A minimum amount of time that the business must consistently operate within the jurisdiction, financial restrictions on the types of activities that are covered are all possible thresholds like auxiliary activities.

This concept is the right step in the direction to bring the digital markets under the purview of permanent establishment and it is a multilateral approach to bring digital markets under the purview of international taxation.

## VII

### THE DOMESTIC FRAMEWORK FOR PERMANENT ESTABLISHMENT

The basis for establishing a "business connection" or "Permanent Establishment" is specified by Indian law. According to Section 9(1)(i) of the Income Tax Act, 1962 read with the corresponding Explanation, the amount of income generated from a "business connection" in India is liable to be taxed in India to the degree that it may be properly linked to operations conducted in India. In Income Tax Rules, 1962, under Rule 10 if it is the opinion of the Tax Officer that income that a non-resident generates cannot be properly established and calculated, the amount of such income may be calculated by taking into consideration the percentage of turnover or an amount which is indicative of the profit or receipts that are accrued by the business.

Additionally, the Equalization Levy was created by The Finance Act, 2016 and focused on particular transactions between residents and non-residents. The first levy rate for digital advertisements was 6% of what non-residents of India were paid in consideration. Since the government usually suffers from revenue loss owing to untapped tax revenues, this levy was introduced as a means to gain tax revenue by taxing the digital presence of a non-resident by means of advertising. It is clear that the advent of digital technology has revolutionised how businesses operate and has had an impact on more than just marketing and advertising.

The Finance Act 2020 expanded the levy charge from 2020 so that the Levy will be charged at 2% of the income that is earned by an e-commerce enterprise from all online sale of services and goods. The person liable to pay the tax should be a resident of India or using the IP address in India or under certain condition, a non-resident as well. A non-resident of the nation who operates or owns a digital or electronic facility or platform is referred to as an e-commerce operator. In contrast to how the Levy was previously applied, the

operator is now responsible for directly meeting the compliance criteria on a quarterly basis. The operator's receipts that are covered by the levy as described above are exempt from additional taxes in India.

The Levy would not, apply in the case the turnover is less than 2 crores or there is PE established for the enterprise or those who fell in the category of levy in 2016. Additionally, the inclusion of "services" expands the scope of taxation by acknowledging the increasing use of digital platforms for the delivery of diverse services like streaming services, etc. Even though some of the operations that produced these profits, such R&D, production, marketing, and sales, might not have taken place in India, applying a global profit rate to sales made specifically in India would yield an estimate of the overall earnings from Indian turnover. For instance, in some circumstances, certain marketing initiatives and the negotiation of contracts happened in India, while all other activities, including R&D, production, technical services, etc., may have happened elsewhere. The Indian judiciary has typically used an ad hoc method to determine the earnings generated to activities specific to India on case-to-case basis.

The equalisation levy, in contrast to the virtual permanent establishment, is in realm of unilateral approach which can lead to double taxation and it can have a drastic effect on cross border trade as well as the structure of international taxation.

## VIII

### DOMESTIC PRECEDENTS

In the case of *Anglo-French textile Co. Ltd. v. CIT*<sup>13</sup>, for instance, according to the facts of the case, the Supreme Court of India reached the conclusion that 10% of profits should be attributed to activities carried out in India.

In case of *DIT v. Morgan Stanley*<sup>14</sup>, the Supreme Court mentioned "software pe," but failed to provide its definition. The court further stated that since the associated enterprise's compensation had already been calculated using the transfer pricing principle and the principle of arm's length and hence, there was no further need to attribute profits to it in the case of Morgan Stanley, which attributed to be a service permanent establishment.

In *Galileo International Inc. Dy. CIT*<sup>15</sup>, the Indian permanent establishment was a part of contract negotiations, a certain percentage of the overall venues were

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<sup>13</sup> *Anglo-French Textile Co. Ltd. (II) v. C.I.T.*, (1952) 2 S.C.C. 790.

<sup>14</sup> *DIT (International Taxation) v. Morgan Stanley & Co. Inc.*, (2007) 7 S.C.C. 1.

<sup>15</sup> *Director of Income-Tax v. Galileo International Inc.*, 2009 SCC OnLine Del 4266.

deemed to be attributable to it. The Appellate Tribunal determined that a permanent establishment was set up in India because Galileo had a business relationship with India because the Company made equipment available to travel agents in India continuously and there was a fixed place of business because some of the reservation services used by Galileo's system were performed on the clients' premises where the computers were located.

In the case of *Verizon Communications Singapore Ltd v. IT Officer*,<sup>16</sup> The court gave significance to the virtual presence of the company and the role this virtual presence plays in establishing a business in any area when considering the question of royalty income to be generated by the company when making a payment outside India.

In *MasterCard Asia Pacific Ltd v. Union of India*,<sup>17</sup> the applicant, MasterCard Asia Pacific, gave customers a MasterCard Interface Processor, which links to MasterCard's network and processing facilities. This Interface is owned and maintained by an Indian subsidiary. The main question that arose that whether a permanent establishment came to be when transactions were made using this payment mechanism. It was held that it would not be counted under royalty owing to the Singapore India DTAA and would be taxed under Article 7.

In case of *LG Electronics Inc. Korea vs. Deputy Commissioner of Income-tax*,<sup>18</sup> it was ascertained that the company manufactured and sold household appliances. LG India was the subsidiary of the company in India which had engaged many transactions for the purpose of sale of goods but LG India did not deduct taxes from these transactions because no part of the income from these supplies was generated in India. According to the Assessing Officer, LG India was financially dependent on the main company it exercised almost a complete degree of control over the Indian counterpart and hence, the company had a fixed place PE in India under the provisions of articles 5(1) and 5(2).

In *Union of India v. U.A.E. Exchange Centre*,<sup>19</sup> the Supreme Court held that a business that provides financial services did not have a permanent establishment in India as it was held that these services are preparatory in nature and the presence of an Indian office did not grant it the nature of a permanent establishment.

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<sup>16</sup> *Verizon Communications Singapore Pte. Ltd. v. Income Tax Officer International Taxation-1 Chennai*, 2012 S.C.C. OnLine I.T.A.T. 8582.

<sup>17</sup> *MasterCard Asia Pacific (P) Ltd., In re*, 2018 S.C.C. OnLine AAR-IT 12.

<sup>18</sup> *LG Electronics Inc. Korea (LGEK) v. C.I.T.*, 2019 S.C.C. OnLine I.T.A.T. 18661.

<sup>19</sup> *Union of India v. U.A.E. Exchange Centre*, (2020) 9 S.C.C. 329.

## OTHER ALTERNATIVES FOR TAXATION IN A DIGITAL ECONOMY

Some other alternatives for taxation in digital economy have already been discussed such as the *equalisation levy* and the *two-pillar solution* proposed by OECD under BEPS Action 1 Plan which will shift taxing rights to the countries where a business is operating regardless of a place of business and fix a minimum threshold for global corporate tax for companies.

Moreover, *data localisation requirements* for a company to store data locally could also lead to establishing a place of business and help in taxation of that company by help of a physical presence in the jurisdiction.

Moreover, a *Digital Services Tax* can be imposed on companies for taxation purposes. The DST is like the equalisation levy but it is imposed on the revenue generated through digital services provided by a company rather than on the payments made to a company for the services.

## X

## CONCLUSION

Digital Economy has affected all the spheres of the globe today with the regulation for the same being an essential requirement for nations. The nations need to legislate their rules and regulations by keeping in mind the boom in digital economy and ecommerce. Fields like competition law, taxation law, banking law all need to be reorganised to deal with the issues of ecommerce and therefore, the concept of permanent establishment becomes more prominent. The need to establish the permanent establishment of any enterprise arises from the fact that if a PE is established it is easier to apply the laws of the state to the enterprise. This would also ensure that the state does not lose on the revenue from taxation and that enterprises do not misuse the advancement of technology to evade the taxes of the nation from where they earning their substantial part of the revenue while a virtual permanent establishment approach would better serve the purpose of international trade rather than unilateral measures such as equalisation levies.